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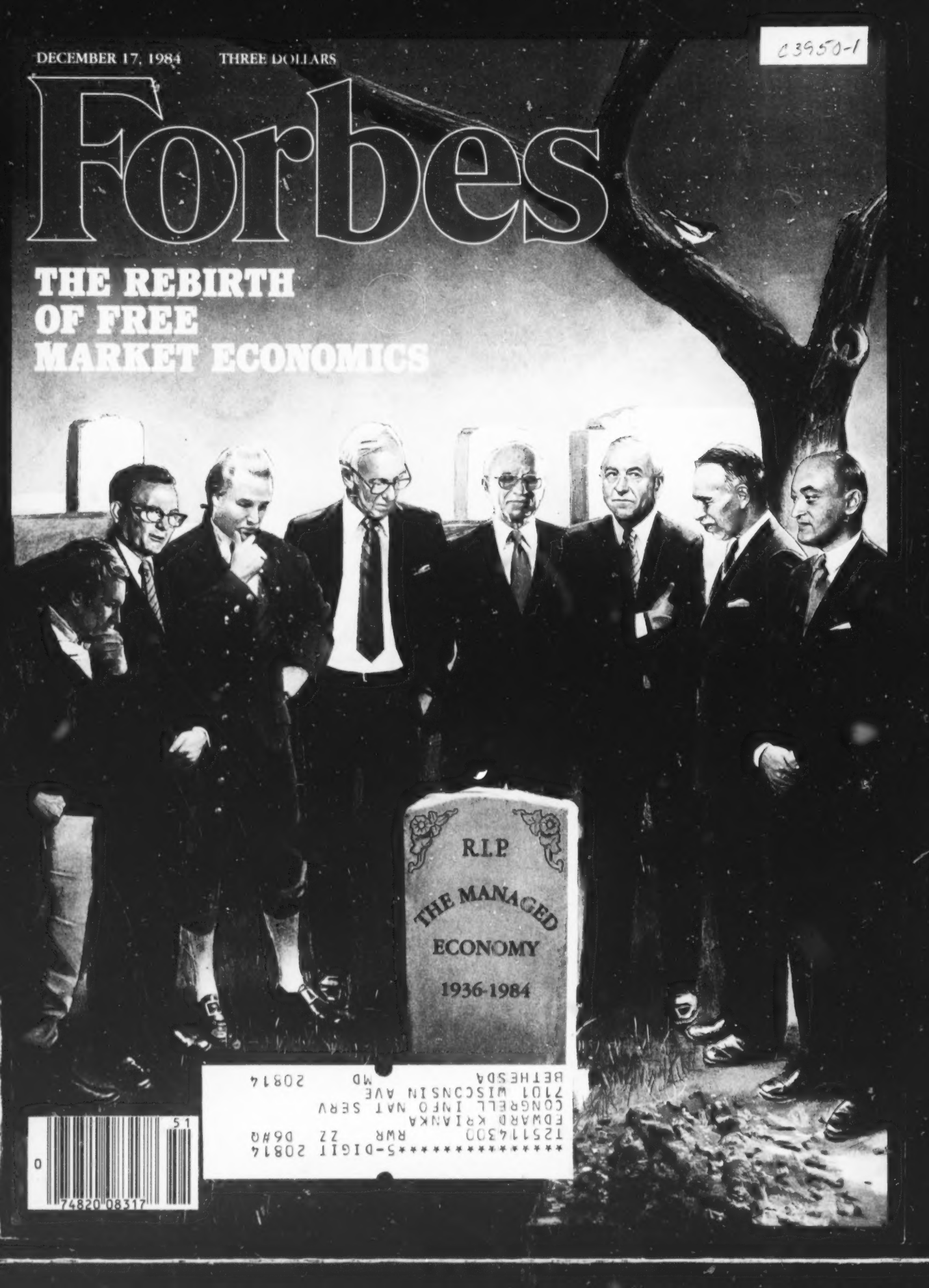
DECEMBER 17, 1984 THREE DOLLARS

Forbes

THE REBIRTH OF FREE MARKET ECONOMICS



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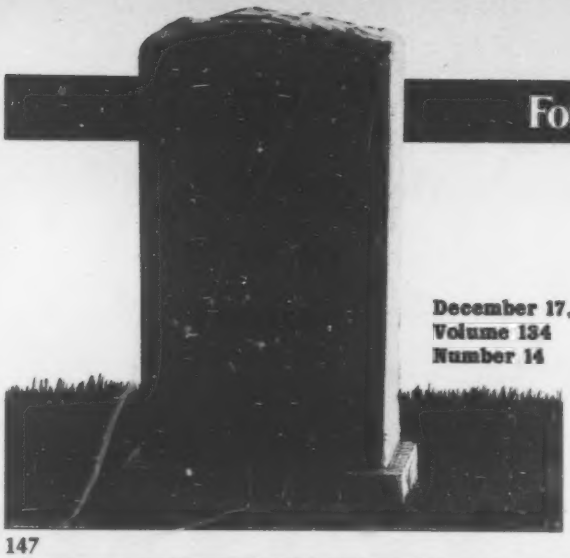

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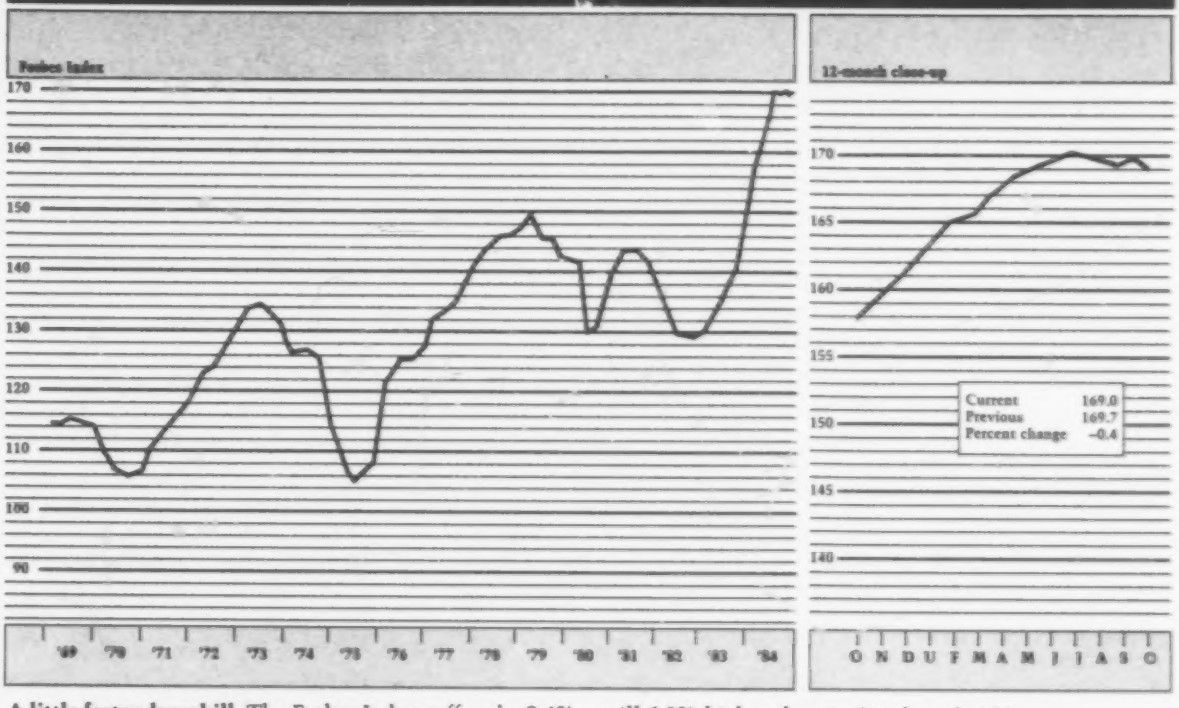
Cover illustration by: Alan Reingold

The Forbes Index



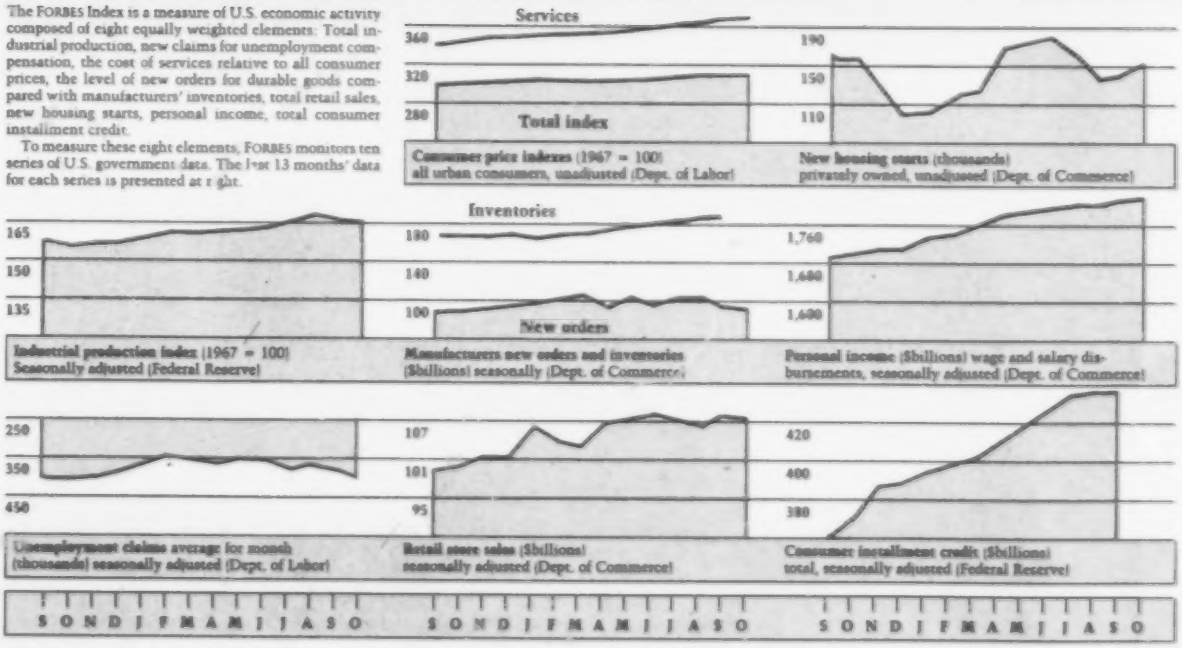
A little faster downhill. The Forbes Index suffered a 0.4% decline in the latest reporting period. This is the largest setback since the Index began losing ground in August. At present, however, the figures are more indicative of a slowdown than a recession. Manufacturers' new orders fell 4.1% from the previous month. Although retail store sales declined 0.1% from September to October, they are still 6.8% higher than in October of 1983.

While new housing starts show a 1.1% month-to-month gain, they are down 5.8% from a year ago. Personal income rose 0.2% over the previous month, but latest figures also show a 1% rise in consumer installment credit. If debt burdens continue to rise faster than salaries, consumers could end up in a bind.

The Forbes Index Components

The FORBES Index is a measure of U.S. economic activity composed of eight equally weighted elements: Total industrial production, new claims for unemployment compensation, the cost of services relative to all consumer prices, the level of new orders for durable goods compared with manufacturers' inventories, total retail sales, new housing starts, personal income, total consumer installment credit.

To measure these eight elements, FORBES monitors ten series of U.S. government data. The last 13 months' data for each series is presented at right.


Services
360
320
280
Total index
Consumer price indexes (1967 = 100) all urban consumers, unadjusted (Dept. of Labor)
190
150
110
New housing starts (thousands) privately owned, unadjusted (Dept. of Commerce)
Inventories
180
140
100
New orders
Manufacturers new orders and inventories ($billions) seasonally (Dept. of Commerce)
165
150
135
Industrial production index (1967 = 100) Seasonally adjusted (Federal Reserve)
1,760
1,680
1,600
Personal income ($billions) wage and salary disbursements, seasonally adjusted (Dept. of Commerce)
250
350
450
Unemployment claims average for month (thousands) seasonally adjusted (Dept. of Labor)
107
101
95
Retail store sales ($billions) seasonally adjusted (Dept. of Commerce)
420
400
380
Consumer installment credit ($billions) total, seasonally adjusted (Federal Reserve)
S O N D J F M A M J J A S O
S O N D J F M A M J J A S O
S O N D J F M A M J J A S O

Biotechnology is on its way to becoming a great industry. But early investors in biotech won't get rich from it.

Dream delayed, dream denied

By Robert Teitelman

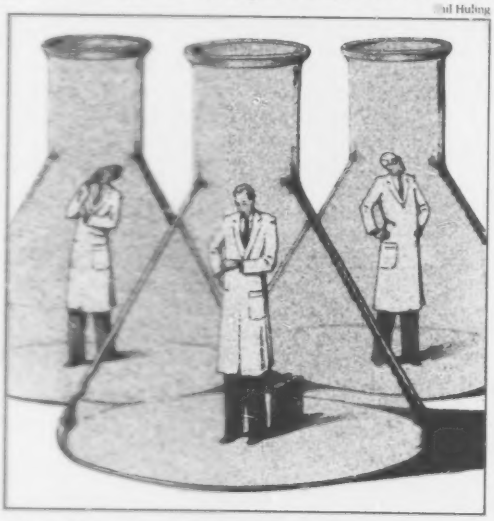
THE DREAM THAT DROVE investors in recent years to pour hundreds of millions into biotechnology companies is troubled these days. True enough, laboratory experiments with recombinant DNA and monoclonal antibodies are yielding new and useful substances, from compounds to help children grow, to medicines that may cure or alleviate cancer.

But making scientific breakthroughs is a long way from getting profitable products to market, and investors are discouraged. Genentech, Inc., the San Francisco-based firm, all but started the biotech boom when investors stampeded its initial sale of stock in October 1980. Genentech sells above its first offering, but many of the 75 or so biotech companies that went public since are selling well below the offering *(see table, p. 37)*.

Even Genentech, the strongest of the biotech startups, faces difficulties, although the company's record of scientific achievement is unmatched in the field.

Genentech's two founders are Herbert Boyer, Genentech director and University of California biochemist, who was one of the pioneers of gene-splicing in the mid-1970s, and Robert Swanson, the company's president and chief executive. The company has led the industry in a number of important areas: engineering the gene for human insulin and developing tissue-type plasminogen activator, or t-PA, an enzyme that dissolves heart-attack blood clots.

Staffed with over 130 Ph.D.s among its 655 employees, Genentech has ambitions to be a truly big company. "I don't think we'll be a billion-dollar company in five years," says Treasurer Shirley Liu Clayton, a Stanford M.B.A., "but we expect to have several hundred million dollars in revenues by then." The great expectations are founded on five major projects:



- Human growth hormone, which has already been submitted to the Food & Drug Administration for approval as a drug to combat the 10,000 or so cases of growth hormone deficiency in American children. Clayton estimates the initial market could be anywhere from $20 million to $40 million a year.
- Gamma interferon. Scientists believe this form of interferon has antiviral and anticancer properties. But they're still unsure exactly how it works within the body's immune system. Currently, gamma interferon is well into clinical testing, the stage of product development that precedes filing for FDA approval. "If gamma proves effective against a couple of major cancers, it would be a fantastic product," says Clayton. "I would say many millions of dollars."
- Tumor necrosis factors, a family of anticancer compounds in preclinical testing. The factors may kill tumors by shutting down their blood supply. Clayton estimates tumor necrosis factors would be worth hundreds of millions in revenues.
- Bovine interferon, a form of interferon used against an upper respiratory viral infection in cows. Granada Corp., a private Texas feedlot operator, paid Genentech $20 million to do the research and testing.
- Tissue-type plasminogen activator. This is Genentech's big hope. With 1.5 million heart attacks in the U.S. a year—approximately half the victims die—this could be a big seller if and when it gets approval at the FDA. Taylor estimates a market of several hundred million dollars.

Genentech has financed its research to date by selling stock to the public and by doing contract research for others. After the initial offering in 1980, a 3-for-2 split in 1983 and a number of private placements, it has 14.5 million shares outstanding, for a market value of $486 million. Genentech even has earnings: $1.13 million in 1983 on $47 million in revenues, although much of the profit comes from interest on its cash balances.

But from here on, the road gets harder. To get marketable products from its research will demand three to ten years and hefty expenditure. "The work the biotech companies have done so far costs only one-tenth of what it will cost them to get a product to market," says David Wheat of Arthur D. Little. "It gets progressively more expensive as you go through scale-up, regulatory approval and into marketing and distribution."

Some of the projects undoubtedly won't make it beyond the research stage. For those that do, Genentech faces the further challenge of creating a market as well as a product. Says Wheat: "Genentech, which has never marketed a product, will be trying to build a brand-new market." The estimated cost of bringing, say, gamma interferon to market could be as much

as $60 million, if there were no major problems.

And, at least on interferon, Genentech already faces competition from big companies—Hoffmann-LaRoche, Bristol-Myers and G.D. Searle are developing gamma interferon—and from advancing technology. Amgen has developed second-generation consensus interferon that may leapfrog earlier versions, including Genentech's.

Add it up, and you get a stock with a current price that discounts a great deal that hasn't yet happened. Says Jules Marx, managing director of Whale Securities and editor of *MedTech Advisor*, "If you take a 10% net margin on 1989 sales of, say, $500 million," and discount for the cost of capital over the next five years, "you would end up with profits of about $30 million in today's dollars." Thus, Genentech is selling at 16 times the present value of estimated 1989 earnings, and those earnings may or may not be achieved.

On the way to successful products, moreover, Genentech shareholders face a good deal of potential equity dilution. The company sold two research and development partnerships (a third is in the works); the three will bring in $120 million in off-balance-sheet financing. Investors in the partnerships will get tax losses while the proposed products are in the red, and royalties when and if they become profitable. The investors will also get a chance to exchange their partnership interests for either cash or stock. The R&D partnerships could add at least 3 million shares to Genentech—a 21% dilution.

The implications are obvious. As the research and testing absorb more cash, the likelihood of Genentech's becoming a giant company, as opposed to a small and highly regarded research outfit, grows more remote. The Lubrizol Corp. (which recently agreed to acquire one biotech company, Agrigenetics Corp.) owns 14% of Genentech's stock. It's possible that this brightest of the biotech startups will ultimately be forced by capital needs to become a big company's subsidiary.

If Genentech is a question mark, what about the lesser companies in the field? Looking at the silver lining in their dark prospects, Wall Street talks of profitable buyouts. The thinking is that investors in biotechnology companies will recoup something when they are bought out by the drug and chemical giants. Will the big companies pay high premiums for companies whose principal assets—their scientific minds—go down in the elevator every night? Maybe, maybe not.

The trouble is that the dream that promised a payoff in biotech contained a flaw not present in other high-tech fields. Unlike entrepreneurial companies in computers and semiconductors, the biotech startups had no products. Payoffs to investors come from profitable products, not from basic research. The fledgling biotech companies are a long way from having such products. ■

Equity engineering

Most biotech stocks are selling below initial prices but are no bargains. In many cases, R&D partnership interests will dilute stockholders' equity.

	Initial offering price	Recent price	Equity	Debt	R&D limited partnership	R&D as % of equity
			(millions)			
Amgen	18	4¼	$59	$8	—	0%
Cetus	23	10	136	5	$ 75	55
Genentech	35	50¾*	96	5	120	125
Genex	9½	8⅛	49	9	—	0
Centocor	14	10¼	29	—	—	0
Collaborative Research	11	5¼	36	—	—	0
Molecular Genetics	9	6½	37	—	11	30
Hybritech	11	15½	61	1	77	126
Biogen	23	5¼	125	3	26	21
California Biotechnology	12	5¼	16	—	28	175

*Adjusted for splits. *Source: Whale Securities.*

Hollywood producers, the Central Casting cliché has it, are cigar-chewing mogul types. But a good many producers think of themselves as exploited workers. And just look to whom they have turned for help.

Labor pains

By Alex Ben Block

THE MOST RECENT additions to the roster of fee-paying affiliates of the 1.9 million-member International Brotherhood of Teamsters are more likely to be driving Mercedes than 18-wheelers. They are members of the Producers Guild of America, Inc., representing 800 producers of movies and television shows. PGA members last month voted overwhelmingly to become independent affiliates of the Teamsters. The producers hope the threat of a strike by Teamster drivers and others will finally give them enough clout to force major studios and TV production companies to come to the bargaining table, thus ending years of frustrating indifference.

The battle until now has centered on definition. Is a producer management or labor? There can be no doubt, the PGA argues, that the vast majority of producers are the latter. "The producer is the individual hired to go in and manufacture the product for the production company," says Charles B. FitzSimons, 60, a working TV producer (*Goodnight Beantown*, etc.) and executive director of the PGA. "Unlike

David Stockman opposed it. But Mark Hatfield sold it, Ronald Reagan signed it and the country's lumbermen love it.

The great timber bailout of 1984

By Kathleen K. Wiegner

MEXICO ISN'T THE ONLY PLACE where debt is renegotiated. It's also done in Region Six. That's the U.S. Forest Service's designation for an area encompassing the Northwest's great conifer forests in Washington and Oregon. In the late 1970s and early 1980s, timber-poor lumbermen, particularly those west of the Cascade range, signed timber-cutting contracts with the Forest Service for 9.7 billion board feet at around $310 per thousand board feet (FORBES, *Jan. 30*). Today the price is around $86 per thousand board feet. Forcing the lumbermen to honor their timber contracts could have cost the industry over $2 billion and bankrupted several sizable firms.

According to estimates by Salomon Brothers analyst H.C. Bowen Smith, Eugene, Ore.-based Bohemia Corp. could have lost over $138 million—$42 million more than Bohemia's net worth. Medford, Ore.-based Medford Corp.'s $76 million timber contract liability would have wiped out its $61 million net worth *(see table)*.

Ronald Reagan to the rescue. On Oct. 16 the President bailed out the lumbermen by signing into law HR 2838. In effect, the law gives timber companies the chance to pay for their folly in increments that should cause little financial damage to all but a handful of the smallest outfits. The bill could, for example, cut Bohemia's potential contract loss from $138 million to $63 million, Medford's from $76 million to $17 million.

The timber bailout shows political maneuvering at its most artful. Less than a year ago, chances for legislation looked as bleak as the timber companies' balance sheets. Reagan was against any bailout. Even the forest products companies were fractionalized. A dozen small, privately owned timber companies that had not engaged in the bidding frenzy of the late 1970s opposed relief on the grounds that it would only encourage further speculative excess. Southern timber companies, which buy little or no federal timber, also opposed a bailout. They worried that if contracts were terminated, the Forest Service would throw billions of board feet of unharvested trees on the market, further depressing the already low price of standing timber in the Northwest. Big outfits such as Boise Cascade and Potlatch were cool to the inequity in proposals that helped only small companies west of the Cascades.

Knotty questions

How much exposure forest products companies have with their high-cost federal contracts is both controversial and complex. How much timber eventually will be turned back will not be known until next year. Remaining volumes can be cut over the next five years. If wood-product prices recover, remaining potential loss would be reduced. Total unharvested volumes are as of June 30, 1984; potential losses, as of Aug. 31, 1984.

Company	Net worth	Total volume	Potential loss	Buyout volume	Potential loss removed	Buyout cost	Remaining potential loss
Bohemia	$ 96	566	$138.4	202	$75.8	$2.0	$62.6
Boise Cascade	1,423	851	119.8	209	62.1	11.5	57.8
Champion International	1,830	442	89.0	201	63.6	11.1	24.9
Georgia-Pacific	2,125	140	37.9	89	28.4	4.0	9.5
International Paper	3,374	236	43.2	137	34.9	5.1	8.3
Louisiana-Pacific	752	147	102.2	203	49.2	10.6	53.0
Medford Corp	61	250	75.6	151	58.5	1.5	17.1
Plum Creek Timber*	4,027	280	25.5	201	22.2	3.9	3.3
Pope & Talbot	112	271	72.0	203	60.8	5.8	11.2
Publishers Paper†	1,183	362	73.0	201	54.5	8.7	18.5
Southwest Forest	205	536	141.9	202	86.1	15.6	55.8
St Regis Corp	1,411	141	11.6	123	11.1	1.9	0.5
Weyerhaeuser	3,260	66	5.0	42	4.1	1.2	0.9
Willamette Industries	413	343	85.6	200	59.9	10.3	25.7

Dollars in millions, volume in million board feet. *Subsidiary of Burlington Northern. †Subsidiary of Times-Mirror. *Sources: Timber Data Co.; Salomon Brothers.*

The $64,000 question.

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The task of building a coalition powerful enough to bend Reagan's mind fell to two experienced Oregon pols—Republican Senator Mark Hatfield, who had spent three years fighting for some sort of relief for his constituency, and Democratic Representative Les AuCoin, who had introduced a contract relief bill in 1981. Both men were up for reelection this year, so the pressure to perform was on. Both won reelection.

Hatfield and AuCoin zeroed in on Senator Howard Metzenbaum, the Ohio Democrat who had threatened to filibuster any legislation that did not include a "needs test." Metzenbaum had opposed earlier timber contract relief bills on populist grounds,

The timber bailout shows political maneuvering at its most artful. Less than a year ago, chances for legislation looked as bleak as the balance sheets of the timber companies.

arguing they might treat large companies less severely than smaller ones. But Hatfield and AuCoin convinced Metzenbaum they wanted to bail out companies in proportion to their need, not their size.

Southern timber interests had to be brought around, too, of course. Eventually the Northwest lumbermen convinced the Southerners that a wave of bankruptcies in the Northwest would hurt everyone, specifically on Wall Street. The South bought the argument and endorsed legislation hammered out by Metzenbaum and Hatfield.

No one could deliver Budget Director David Stockman and Assistant Agriculture Secretary John Crowell Jr. (who is responsible for the Forest Service), who remained unalterably opposed to the bailout. But no one, it turned out, had to. Without fanfare, Reagan signed HR 2838 just one day before it would have expired.

HR 2838 amounts to a nifty piece of debt restructuring. In general, it allows lumbermen to pay off much of their timber contract liabilities at pennies on the dollar. The bill says companies can buy out of up to 55% of their cutting contracts, up to a maximum of 200 million board feet of contracted volume.* The other 45% must be harvested under the terms of

* *Most contracts are in the range of 200 million to 300 million board feet. The largest contracted volume, 851 million board feet, is held by Boise Cascade.*

the original contracts, some of which run until 1989. Companies have until mid-April of next year to decide how much timber to return.

What price the buyout? To make sure big companies were not favored relative to little ones, Metzenbaum got his needs test; companies with greater financial strength pay more to buy back their cutting liabilities. Thus, according to Salomon Brothers' Bowen Smith, Bohemia (whose potential contract losses equal 144% of its net worth) can eliminate $76 million worth of potential timber contract losses by paying $2 million. But healthier Champion International, whose potential loss equals 5% of net worth, would have to pay $11 million to wipe out $64 million of potential losses.

And how were the southern timber interests taken care of? HR 2838 puts a cap on the amount of Region Six timber the Forest Service can sell. Over the next seven years, total Forest Service timber sold but unharvested may not exceed 12.3 billion board feet (about a three-year supply). Sales in any one year may not exceed 5.2 billion board feet. The southern lumbermen like that provision because it removes the threat of massive clearance sales by the Forest Service that would undercut their price structure.

Contract relief does not solve the fundamental problems of the Northwest timber industry: overcapacity, high raw material, labor and transportation costs and increasing competition from cheaper Canadian products. Nor will it prevent defaults by companies that find even the relief offered inadequate. It merely buys time.

The government could receive around $400 million, as companies buy out of their contracts. And the Forest Service and Bureau of Land Management might get back as much as 7 billion board feet of timber, worth around $600 million at current prices.

So how much, net, will the great timber bailout cost the Treasury? It's hard to say precisely. David Stockman told Congress that HR 2838 would cost the government $400 million it might have collected from those companies that could honor their contracts. Congress' in-house research arm put the cost at $1 billion. Not exactly small change either way. But lumbermen, like central bankers in Mexico and Brazil, argued the government was better off with something from a surviving industry than nothing from a bankrupt one.

Persuasive logic, that, even if it does make nonsense of the definition of the very word "contract." ■

The $20.00 answer.*

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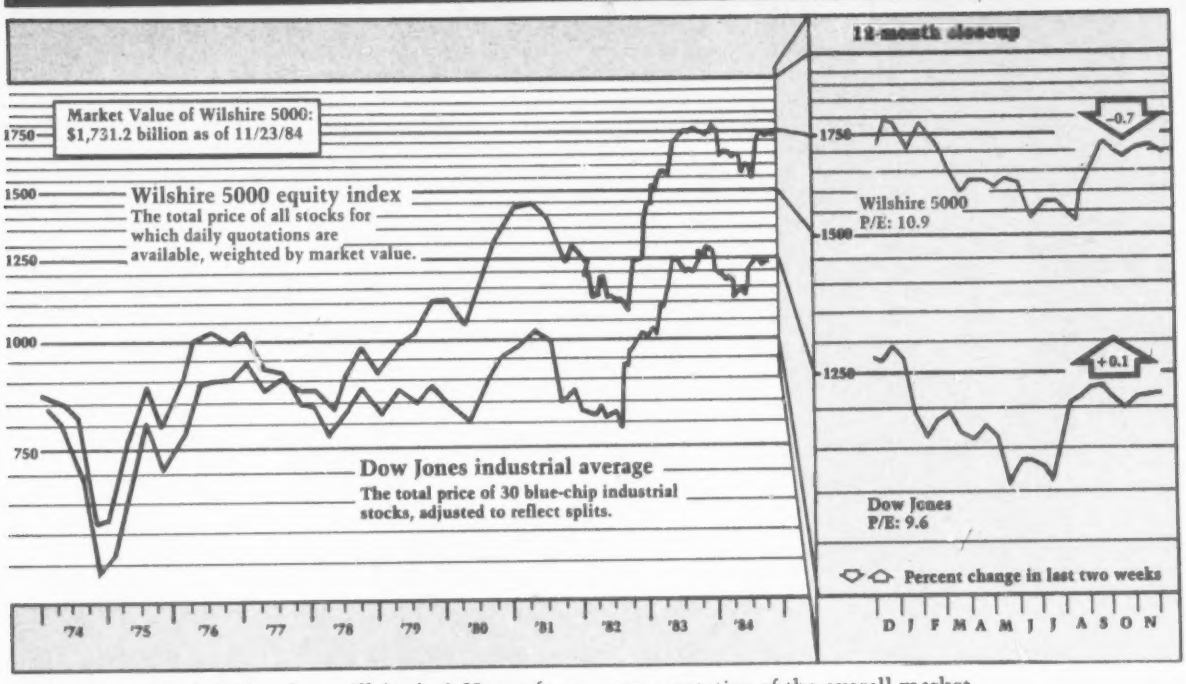
*Approximate price 750 ml bottle, which will vary depending on location of purchase.

The Forbes/Wilshire 5000 Review


12-month closeup
Market Value of Wilshire 5000:
$1,731.2 billion as of 11/23/84
1750
1500
1250
1000
750
Wilshire 5000 equity index
The total price of all stocks for which daily quotations are available, weighted by market value.
Dow Jones industrial average
The total price of 30 blue-chip industrial stocks, adjusted to reflect splits.
-0.7
Wilshire 5000
P/E: 10.9
+0.1
Dow Jones
P/E: 9.6
Percent change in last two weeks
'74 '75 '76 '77 '78 '79 '80 '81 '82 '83 '84
D J F M A M J J A S O N

Perhaps it stopped falling, but will it rise? Hopes for a quick postelection rally quickly faded as the Dow fell 58 points between Nov. 6 and Nov. 19. Following that, the market began to make up for some lost ground. Most of the broad indicators finished the last two weeks with only minor losses. The more than 5,600 issues that make up the Wilshire index fell 0.7%, and the NYSE composite dropped by the same amount. NASDAQ shares suffered the sharpest loss with a 1.6% decline, while Amex-listed issues were off 0.7%. Although the 30 blue-chip issues making up the Dow industrials managed to eke out a 0.1% gain during the two weeks, this movement was not representative of the overall market.

Are better days ahead? Leading economic indicators are pointing downward, earnings estimates continue to fall, the Wilshire index is already selling at almost 11 times latest 12-month earnings, and upward volume has been unspectacular. On the other hand, institutions currently have around 13% of their portfolios tied up in cash. That's around $130 billion they could pour into the equity markets. This compares favorably with the cash position prior to the August 1982 rally. Portfolio managers, however, are unlikely to plunge into the market without some surprising good news.

Close-up On The Equity Markets

Performance of six leading indexes

Percent change	Wilshire 5000	Forbes 500[1]	Dow Jones industrials	NYSE Composite	Amex Market Value Index	NASDAQ Composite
in last 4 weeks	0.6	1.0	1.3	0.8	0.0	–0.8
in last 52 weeks	–3.1	0.5	–4.5	–0.5	–6.0	–14.0

Stock performance based on six key investor yardsticks

Percent change	Company size		Volatility[2]		P/E multiple		Dividend yield		Growth profile[3]		Share price	
	large	small	high	low	over 25	under 5	over 7.5%	none	high	low	over $40	under $4
in last 4 weeks	1.3	–3.0	–2.9	0.6	–3.0	0.5	1.4	–2.7	–3.2	1.2	0.9	–3.1
in last 52 weeks	–1.4	–8.0	–15.1	10.0	–19.5	6.3	6.9	–12.8	–12.2	7.9	2.7	–16.4

[1]Based on sales.
[2]A stock's sensitivity to overall market movement. High-volatility issues have wide price fluctuations, low-volatility issues are more stable.
[3]A quantitative evaluation of a stock's growth image, determined by Wilshire Associates.

Note: All data for periods ending 11/23/84. Prepared by Wilshire Associates, Santa Monica, Calif.

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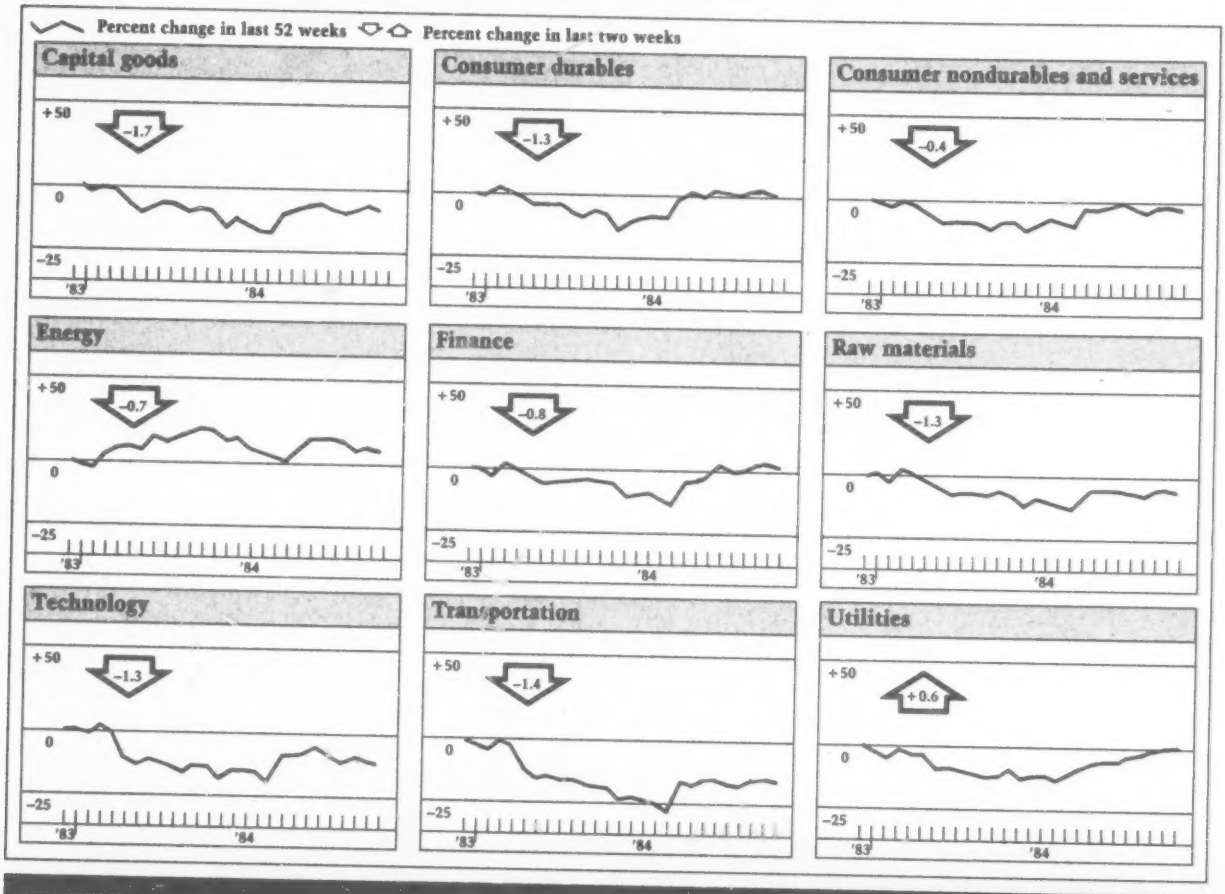
Where The Action Is

Utilities on top. All Wilshire sectors lost ground during the latest two-week stretch except for the utilities, which registered a 0.6% gain. Utility stocks also showed the best four-week performance, with a 2.3% rise. Declining interest rates and poor performance of many industrial issues are, once again, attracting investors to the safe and attractive yields offered by many utility shares.

Over the last two weeks only one other Wilshire sector, consumer nondurables, fared better than the overall market. While the broadly based Wilshire index lost 0.7%, consumer nondurables declined by only 0.4%. Energy shares paced the Wilshire with a 0.7% loss, while capital goods showed the poorest performance with a 1.7% drop in value.



What The Analysts Think

Falling 1985 estimates. With third-quarter figures on the books, security analysts are making slight—and mostly downward—revisions in 1984 earnings estimates. But the cuts in 1985 estimates are running much deeper. For example, in four weeks the forecasts for The Forbes 500 have been cut from an average of $4.58 to $4.47 a share.

Forecasting the Forbes 500

Performance period	Average earnings per share	P/E
latest 12 months	$3.11	10.8
1984 estimates	3.91	9.3
1985 estimates	4.47	7.6

Rank based on change in estimate	Sector	Estimated 1984 EPS	% change in 1984 estimate in 2 weeks	in 4 weeks
1	Utilities	$3.54	-0.23%	-0.39%
2	Capital goods	2.75	-0.75	-1.42
3	Transportation	2.46	-0.91	-1.04
4	Energy	2.61	-0.95	-1.62
5	Finance	3.25	-0.96	-1.03
6	Consumer non-durables	2.63	-1.24	-1.74
7	Raw materials	2.58	-1.36	-1.76
8	Consumer durables	3.39	-1.43	-1.36
9	Technology	2.55	-1.45	-1.86

Earnings projections are equal-weighted consensus estimates from over 1,800 security analysts. Forecasts for the 9 Wilshire sectors are limited to firms with 3 or more estimates, with a mean estimate greater than $0.50. Data are compiled and updated weekly by Zacks Investment Research, a Chicago-based quantitative consulting firm.

Note: All data for periods ending 11/23/84. Prepared by Wilshire Associates, Santa Monica, Calif., Zacks Investment Research, Inc., Chicago, Ill.

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